

No. 20,863

United States Court of Appeals

For the Ninth Circuit

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COMMISSIONER OF INTERNAL REVENUE,  
*Petitioner,*

VS.

OSCAR E. BAAN and EVELYN K. BAAN,  
*Respondents.*

On Petition for Review of the Decision of the  
Tax Court of the United States

BRIEF FOR RESPONDENTS

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### BRIEF FOR RESPONDENTS

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#### OPINION BELOW AND JURISDICTION

The opinion below and the basis for jurisdiction of this Court are as stated in petitioner's brief (Pet. Br. 1-2).<sup>1</sup>

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#### QUESTIONS PRESENTED

The Pacific Telephone and Telegraph Company ("Pacific"), by action of its board of directors, approved by its shareholders, adopted a plan of reorganization in 1961 pursuant to which the telephone communications businesses conducted by Pacific in the three States of Oregon, Washington, and a portion of Idaho contiguous

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<sup>1</sup>Respondents will use the same form of reference to the record as used in petitioner's brief. Volume I will be referred to as "I-R.," and Volume II will be referred to as "II-R."

to the State of Washington, were divided from the telephone communications business of Pacific in the State of California. Pursuant to this plan, Pacific transferred all of the assets and liabilities pertaining to the operations in the States of Oregon, Idaho and Washington to a newly organized corporation, Pacific Northwest Bell Telephone Company ("Northwest"), in exchange for a single class of Northwest common stock and a \$200 million interest-bearing demand note. Pursuant to the plan, Pacific issued to all of its shareholders rights, represented by short-term transferable stock purchase warrants, to purchase all of the common stock of Northwest at a price of \$16 per share. Rights to purchase 57 per cent of the Northwest stock at said price were issued by Pacific to its shareholders in 1961, and rights to purchase the remainder of said Northwest stock were issued by Pacific to its shareholders in 1963. The \$200 million demand note was refunded by sales to the public by Northwest between 1961 and 1963 of four issues of 20-year debentures in the amounts of \$50 million each. Respondents, herein referred to as taxpayers, owners of 600 shares of common stock of Pacific, received 600 rights in 1961 to purchase Northwest common stock, which rights were exercised by them on October 11, 1961, when the fair market value of the Northwest stock was \$26.94 per share.<sup>2</sup>

The Commissioner determined in his deficiency notice that the receipt of the Northwest stock by taxpayers in

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<sup>2</sup>Petitioner inadvertently misstated that the Northwest stock on the date of purchase had a fair market value of \$26 per share (Pet. Br. 2). The stipulation (I-R. 65), in accordance with the Commissioner's determination (I-R. 20), correctly stated the amount on October 11, 1961, the date of exercise of the rights, as \$26.94.

1961 on the exercise of their rights was taxable as a dividend distributed by Pacific, measured by the difference between the fair market value of the Northwest stock at the date of exercise, \$26.94, and the amount paid in exercise of the rights, \$16 a share.

The Tax Court held that section 355 of the Internal Revenue Code of 1954<sup>3</sup> was applicable to the distribution of the Northwest stock to the taxpayers, and that the exercise of the rights to purchase Northwest stock did not result in any taxable income.

The only question presented on this appeal is whether the Tax Court erred in rejecting the Commissioner's determination and in ruling that section 355 was applicable. The Tax Court's ruling sustained the primary contention made by the taxpayers, and the Tax Court therefore found it unnecessary to pass on alternative contentions of the taxpayers referred to herein.

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### **STATUTES AND REGULATIONS INVOLVED**

The statutes and regulations set forth in the Appendix, *infra*, are the pertinent statutory provisions and Treasury Regulations.

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### **STATEMENT OF THE CASE**

While petitioner's statement of the facts is substantially accurate so far as it goes, certain significant facts have

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<sup>3</sup>Section references throughout will be to the Internal Revenue Code of 1954 unless otherwise expressly stated. Section 355 appears in the Appendix to this brief (App. v-ix).

been omitted. To assist the Court, a more complete statement of the pertinent facts is set forth.

Taxpayers Oscar E. Baan and Evelyn K. Baan, husband and wife and residents of Sausalito, California, throughout 1961 owned 600 shares of the common stock of The Pacific Telephone and Telegraph Company, a California corporation (I-R. 80-81). Pacific furnishes communications services, including local and long distance (toll) telephone services, in the State of California. Prior to July 1, 1961, it furnished such services also in the States of Oregon, Washington and a northern portion of Idaho contiguous to the State of Washington. Pacific Northwest Bell Telephone Company, a Washington corporation, commencing on July 1, 1961, has continuously furnished such services in the territory formerly served by Pacific in Oregon, Washington and Idaho (I-R. 81). In each state in which they operate, Pacific and Northwest are each subject to regulation by a state public utility regulatory authority having jurisdiction over many aspects of the business, including security issues, purchases and sales of property and the like. Both are likewise subject to regulation by the Federal Communications Commission to the extent their business is interstate (I-R. 82).

American Telephone and Telegraph Company ("American"), a New York corporation, has since 1907 owned more than 80 per cent of each class of stock of Pacific. In 1961, American owned 21 telephone company subsidiaries, including Pacific and Northwest, which operated in every state except Hawaii and Alaska (I-R. 82-83).

In 1961, Pacific's capital stock consisted of \$82 million par value of \$100 par voting preferred stock and ap-

proximately \$1,500,000,000 par value of \$14-2/7ths par value common stock (I-R. 84). Pacific's articles of incorporation did not contain any provision for redemption of the preferred stock (Exh. 2-B(1)). In 1961, Pacific had enough earnings and profits to cover the amount which petitioner contends was distributed as a dividend (I-R. 84).

Because of its expanding business, Pacific required a relatively continuous flow of large amounts of new capital (Exh. 10-J). The financing technique Pacific had worked out was to obtain temporary financing through advances from American, evidenced by demand notes due one day after issuance, bearing 4½ per cent interest. Pacific would discharge such advances periodically from the proceeds of issues of its common stock and long-term debentures. In 1961, Pacific's long-term funded debt stood at \$902 million (I-R. 84-85). In 1961, American owned about 90 per cent of Pacific's common stock and about 78 per cent of the preferred stock, in the aggregate 89.62 per cent of the voting power. The minority common and preferred shareholders numbered over 38,000. Pacific's common and preferred stock had for many years been listed and traded on the New York and Pacific Coast stock exchanges (I-R. 85). Since 1954, Pacific had each year been included as an affiliated subsidiary corporation in the consolidated Federal income tax return of American. Commencing with 1961, this return included Northwest as well (I-R. 86).

It was stipulated that Pacific's operations in Oregon, Washington and Idaho prior to July 1, 1961, constituted one or more telephone businesses which were separable

from the California business which Pacific has continued to operate (I-R. 87).

Since World War II, Pacific's business had mushroomed four or five times in size, and the growth was expected to continue at the same rate, particularly in view of the expanding population in California. In terms of capital, Pacific was American's largest subsidiary, and was the eighth largest nonfinancial company in the United States. Its operating territory included one seventh of the continental United States (I-R. 87-88). The growth and enormous size of Pacific generated severe administrative problems, and caused management concern that the company was getting too big to do an effective job (I-R. 88; Exh. 17-Q, President's letter). John O. Einerman, vice president and comptroller, and formerly an officer of American, was asked in 1958 to undertake studies looking toward division of Pacific into two or three corporations. These studies culminated in a plan for reorganization which was first adopted by the directors on January 27, 1961, on Mr. Einerman's recommendation, and was then approved by the shareholders at their annual meeting on March 24, 1961 (I-R. 88-89).<sup>4</sup>

The plan for reorganization provided that Pacific would transfer all of its business and properties in Oregon, Washington and Idaho to Northwest, in exchange for (a) the assumption by Northwest of certain operating liabilities relating to the assets transferred; (b) all of Northwest's single class of capital stock; and (c) a \$200

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<sup>4</sup>The complete plan for reorganization is contained in Exhibit 17-Q, pages 8-13.

million demand note of Northwest bearing  $4\frac{1}{2}$  per cent interest. An integral part of the plan for reorganization was the offering of the Northwest stock to the Pacific shareholders through rights. The first such offering was made in 1961, and the remainder of the Northwest stock was offered in 1963. The plan contemplated that American would exercise all of the rights it was entitled to receive and that American, after completion of the plan, would own about 89 per cent of the Northwest stock (I-R. 91-92; Exh. 17-Q, pp. 8, 10-12).

The advantages of having the business in Oregon, Washington and Idaho operated by a separate corporation owned directly by the Pacific shareholders were considered to be as follows:

1. Top authority closer to communities served;
2. Better recognition of service needs of each community;
3. More flexibility in dealing with customers;
4. Closer relations with employees;
5. Better understanding by public and authorities;
6. More efficient operations;
7. Financing problems, as well as operating problems, would be assumed by Northwest's management;
8. A board of directors with final authority, drawn from the territory served, would replace the then-existing advisory boards; and
9. Pacific's management would be able to concentrate full attention on the needs of California and Nevada (I-R. 90).

The offering of the Northwest stock through the issuance of rights to the shareholders of Pacific pursuant to the plan was intended to serve the additional purpose of providing Pacific with capital funds required by Pacific for operations in California. In each of the seven preceding 12-month periods ended June 30, 1960, Pacific issued common stock and/or long-term debentures in a total amount of \$1,313,750,000, or an average for each of the seven years of \$187,678,600. In the 36-month period from July 1, 1960, through June 30, 1963, Pacific did not issue any additional common stock or debentures (I-R. 92-93).

Before adopting the plan, the management of Pacific considered various alternative proposals for distribution of the Northwest shares. One such proposal was the distribution of the Northwest shares to the shareholders of Pacific without the payment by them of any consideration. This was dropped because Pacific's management was advised by its attorneys that it would be required to charge such a distribution to earned surplus, and it had insufficient surplus for this purpose. Pacific's management was advised that it could create a reduction surplus out of capital against which a distribution of the shares of Northwest could be charged, but such a reduction surplus would be required under California law to be used first to redeem all of the preferred shares of Pacific. Pacific's management was advised and believed that under California law Pacific's preferred shares were not subject to redemption. In addition, the desire of Pacific to raise new capital from the distribution of the Northwest shares would not have been fulfilled by such a method (I-R. 93).

After obtaining the necessary approvals of the regulatory authorities, Pacific caused the organization of Northwest, and on June 30, 1961, transferred all of its business and properties in Oregon, Washington and Idaho to Northwest in exchange for the consideration contemplated by the plan. In addition to the \$200 million demand note and the liabilities assumed, this included a total of 30,460,000 shares of \$11 par capital stock, having an aggregate par value of \$335,060,000. Thereupon Pacific ceased, and Northwest commenced, operation of the telephone business in Oregon, Washington and Idaho (I-R. 94-96).

The total capitalization of Northwest was arranged in such a way as to maintain substantially the same ratios of stock, aggregate debt and surplus as those of Pacific immediately prior to the transfer of assets. The \$200 million demand note of Northwest corresponded to the long-term debentures in the capital structure of Pacific (I-R. 97). The plan provided that within about three years Northwest would refund the demand note through issuance of its own long-term debentures to the public (Exh. 17-Q, pp. 11, 13). Pursuant to the plan this refinancing was carried out through four issues of 20-year debentures of Northwest of \$50 million each, the last issue occurring in December, 1963 (I-R. 63).

In American's consolidated income tax return for 1961, no gain or loss was reported on the transfer of the Pacific assets to Northwest (I-R. 98).

Pursuant to the plan, on September 29, 1961, Pacific issued to its shareholders of record on September 20,

1961,<sup>5</sup> rights evidenced by assignable warrants to purchase about 57 per cent of the Northwest stock. Six rights and the payment of \$16 were required for the purchase of each share of Northwest. The rights would expire, if not exercised, on October 20, 1961. Both the capital stock of Northwest and the rights were listed for trading on the American and Pacific Coast stock exchanges, and trading with respect to each commenced, at first on a when-issued basis, on September 14, 1961 (I-R. 98-99).

On October 11, 1961, taxpayers exercised all of their 600 rights received from Pacific, and acquired thereby 100 shares of Northwest upon the payment to Pacific of \$1,600 (I-R. 100). In their joint Federal income tax return for 1961, taxpayers reported no income or loss from either the receipt or exercise of the Northwest rights (I-R. 65). On September 29, 1961 (the date of issuance of the rights), the value of the Northwest stock determined by public trading was \$26.81 and the value of the rights similarly determined was \$1.77. On October 11, 1961, the day taxpayers exercised their rights, the two values were \$26.94 and \$1.80, respectively (I-R. 20, 65; Exhs. 48-VV and 49-WW). The amount which petitioner is here contending the taxpayers received as a dividend from Pacific is the "spread" between the \$26.94 value on October 11, 1961, and the \$16 offering price (I-R. 20).

As called for by the plan, American exercised all the rights which it received in 1961, and acquired 15,548,140 shares of Northwest. The minority common and preferred shareholders of Pacific exercised rights to acquire

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<sup>5</sup>Petitioner erroneously stated that the rights were issued on the record date (Pet. Br. 5).

1,897,891 Northwest shares. The shares of Northwest thus acquired by the Pacific shareholders in 1961 had an aggregate fair market value of about \$470 million, while Pacific received cash in the amount of about \$280 million. American's consolidated return for 1961 included taxable gain on the sale by Pacific of Northwest stock to the minority shareholders of \$8,739,362.07, but eliminated gain on the sale of such stock to American, as an intercompany transaction (I-R. 101; Exh. 54-BBB).

The offering price under the 1961 rights was set at a meeting of Pacific's directors on August 25, 1961, at which they adopted the recommendation of Mr. Einerman. Mr. Einerman presented to the board a number of factors which he had taken into account (I-R. 102-103). In making his pricing recommendation, Einerman testified that he did not intend to recommend to the board that a dividend distribution be made in this manner (II-R. 34-35, 37).

Pursuant to the plan, Pacific in June, 1963, issued additional rights to its shareholders, permitting them to purchase the remaining 43 per cent of the Northwest stock held by Pacific. The offering price was again set at \$16 per share, but this time 8 rights were required to be exercised for each share. The offering price was set after consideration of essentially the same factors which the board had considered in 1961. As contemplated by the plan, American exercised all of the rights it received, and when the plan was completed, owned about 89 per cent of the capital stock of Northwest. The minority common and preferred shareholders of Pacific owned another 6 per cent (I-R. 104-105; Exh. 54-BBB).

Under the plan there were two offerings of Northwest stock: (1) because of the enormous amount of stock involved, and (2) because of a desire to avoid the receipt by Pacific of more capital, on which it would feel obligated to pay dividends, than it could use currently in its business (II-R. 40, 58-60, 68; Exh. 15-O, pp. 5 and 6). The Tax Court found that the two offerings of Northwest stock were component parts of a single plan and that they must be regarded together as resulting in the disposition of 100 per cent of the Northwest stock (I-R. 109, n. 4).

The Commissioner of Internal Revenue issued his advance ruling (opinion) letter on June 28, 1961, regarding the tax consequences of the planned division of Pacific and distribution of Northwest stock to the shareholders of Pacific through an issue of rights, in part as follows (Exh. 67-000, pp. 5-6):

“(6) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.

“(7) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

“(8) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordi-

nary income to the shareholder so selling or exchanging the rights.

“(9) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 [App. i-iii] in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

“The amount of the distribution, as determined above, will constitute a dividend to the extent provided for in sections 301(c) and 316 of the Code.

“Section 355 of the Code will not be applicable to the receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon exercise of the above-described rights.

“If a consolidated return is filed for the taxable year in which the American Company exercises its rights to purchase stock of the Northwest Company, the dividend distribution will constitute an intercom-

pany transaction to be eliminated under the provisions of section 1.1502-31(b)(1) [App. xxvi-xxvii] of the regulations.”

After an audit of the taxpayers’ return filed for 1961, the Commissioner issued his statutory notice of an income tax deficiency. In arriving at the deficiency determined against the taxpayers in this proceeding, the Commissioner followed his advance ruling under (9) above. The Commissioner determined that the receipt of the Northwest stock by the taxpayers on the exercise of their rights resulted in a taxable dividend to them in the amount of the difference between the fair market value of the Northwest stock at the date of exercise of the rights (\$26.94) and the amount of \$16 per share paid (I-R. 20). The Tax Court decided that section 355 was applicable to the receipt of the Northwest stock by the taxpayers and that they did not receive any taxable dividend. The court found it unnecessary to pass on other alternative contentions made by the taxpayers in support of their position that no taxable dividend income was received by them on the exercise of their rights (I-R. 111). From this holding the Commissioner has filed his petition for review. (A summary of taxpayers’ argument appears *infra*, pages 44-48).

## ARGUMENT

## I

THE TAX COURT PROPERLY HELD THAT SECTION 355 APPLIED TO THE NORTHWEST STOCK RECEIVED BY TAXPAYERS THROUGH THE EXERCISE OF THEIR RIGHTS, AND THAT TAXPAYERS DID NOT RECEIVE A TAXABLE DIVIDEND THEREBY AS THE COMMISSIONER ERRONEOUSLY DETERMINED.

Following World War II, the telephone businesses operated by Pacific in the States of California, Oregon, Washington and Idaho experienced enormous growth, which was expected to continue. The administrative problems resulting from the scope of Pacific's operations and the territory they embraced led to the formulation of a plan for the separation of the businesses and assets of Pacific in the three States of Oregon, Washington and Idaho into a new corporation, Northwest, to have a separate management, and to be owned by the Pacific shareholders. Pacific was advised by its attorneys that it was not possible under the California corporation law to distribute the stock of Northwest to its shareholders prorata out of its capital or surplus. At the same time, Pacific was faced with a need for large amounts of capital funds to provide new plant and equipment for its expanding operations in California.

Had Pacific transferred its assets in the States of Oregon, Washington and Idaho to Northwest for its common stock, and distributed such stock to its shareholders, there would have occurred, in the language of the Tax Court, "a classic case of a tax-free divisive reorganization," or spinoff, to which section 355 (App. v-ix) was clearly addressed (I-R. 115). This much is not disputed by petitioner (Pet. Br. 13-14).

Laying aside the demand note question raised by petitioner, which is discussed at pages 37-43 below, the only factor present here not present in the classic tax-free spinoff case was that the distribution of the Northwest stock was conditioned upon payment of \$16 a share by the Pacific shareholders to Pacific (I-R. 117). Such cash payment served the additional purpose of providing needed capital for Pacific's operations in California (I-R. 92). The means whereby the Northwest stock was distributed by Pacific to the Pacific shareholders was the issuance to them of short-term rights, which required the payment of cash by them to Pacific, in order to receive the Northwest stock. Petitioner's contention that the transfer by Pacific of the Northwest stock to its shareholders was not governed by section 355 essentially revolves around the use of these short-term rights as the vehicle for the distribution of the Northwest stock to the Pacific shareholders. Admittedly, if section 355 applies to the receipt of the Northwest stock by taxpayers, no amount is includible in their income on the receipt of the Northwest stock.<sup>6</sup>

In order to resolve the questions raised by this appeal, it is necessary that a proper analysis be made of the rights to purchase the Northwest stock. Throughout petitioner's brief is a basic misconception of the proper tax treatment of the rights involved in this case. Whether by inadvertence or design, petitioner's brief views these rights in a manner which is irreconcilable with the Com-

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<sup>6</sup>Section 355(a)(1) provides in part: "\* \* \* then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities" (App. vi).

missioner's own rulings, and with the determination of the deficiency proposed against taxpayers based on such rulings. Petitioner makes essentially the same contention, properly rejected by the Tax Court (I-R. 117-118), that the subject of the distribution by Pacific to its shareholders under the plan of reorganization was the rights to subscribe to the Northwest stock, rather than the Northwest stock itself. Petitioner asserts that taxpayers "realized a 'profit' on the distribution of the rights, which is taxable as a dividend, absent a specific statutory exemption" (Pet. Br. 8). Again, petitioner alleges that Pacific "distributed" rights which set a purchase price for the Northwest stock below the fair market value of the stock, and thereby reflected an intention to distribute corporate earnings which, absent an exemption provision, would be fully taxable as a dividend (Pet. Br. 15, 16). The exercise of the rights is considered by petitioner as merely determining the *time* when dividend income in the form of rights was received, and the *amount* of such dividend income (Pet. Br. 16).

This analysis is not only directly contrary to the Commissioner's own rulings and determination which he made in this case, but is completely contrary to the Supreme Court decision in *Palmer v. Commissioner* (1937) 302 U.S. 63, relied on by the Tax Court. The Commissioner ruled (I-R. 106) that no taxable income would result from the receipt of rights by Pacific shareholders to purchase Northwest stock, even though the fair market value of the Northwest stock at the time of issuance of the rights<sup>7</sup>

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<sup>7</sup>The term "issuance" rather than "distribution" is considered to be more accurate here, since these rights were created by Pacific.

might be in excess of the offering price. Additionally, he ruled that if the rights were held until the date of expiration of the rights, without having been exercised, sold or exchanged, no taxable income would result. The Commissioner further ruled that when rights were exercised by Pacific shareholders, and at the time of exercise the fair market value of the Northwest stock was in excess of the offering price, a distribution of property to such shareholders, in the form of Northwest stock, would occur at that time, taxable under section 301 (App. i-iii) (I-R. 106).

In the case of individual shareholders, the Commissioner ruled that the amount of the dividend distribution would be the difference between the fair market value of the Northwest stock at the time of exercise and the \$16 per share offering price. In the case of corporate shareholders, the Commissioner ruled, in substance, that there would be no dividend distribution if the basis of the Northwest stock in the hands of Pacific was less than \$16 per share. The latter ruling was based on the provisions of section 301(b) (I-R. 106). The deficiency notice in this case follows these rulings (I-R. 20).<sup>8</sup>

The Commissioner further ruled as follows: "Section 355 of the Code will not be applicable to the receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon exercise of the above-described rights" (Exh. 67-000, p. 6). Taxpayers are in accord with the Commissioner's rulings referred to as to the nature of the rights issued by Pacific, and that a distribution in the

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<sup>8</sup>See Income Tax Regulations section 1.301-1(j), and *Timberlake v. Commissioner of Internal Revenue* (4 Cir. 1942) 132 F.2d 259, cited by petitioner (Pet. Br. 15).

form of Northwest stock occurred upon the exercise of said rights. Taxpayers disagree, however, with the Commissioner's ruling that section 355 of the Code does not apply to this distribution. If section 355 applies, then section 301 cannot apply to the distribution of the Northwest stock, as conceded by petitioner (Pet. Br. 16). Taxpayers contend that section 355 applies to the distribution of the Northwest stock, and not section 301. This is the primary issue in this case.

In making his advance rulings on the tax treatment of the Northwest rights and holding that exercise of the rights resulted in a distribution of the Northwest stock, the Commissioner followed the decision of the Supreme Court in *Palmer v. Commissioner* (1937) 302 U.S. 63. In the *Palmer* case the Supreme Court considered the question of whether shareholders of a corporation received dividend income when they exercised rights issued to them to purchase the stock of a corporation which was owned by the distributing corporation.<sup>9</sup> At the time the distributing corporation there involved set the purchase price provided for in the rights, the fair market value of the stock subject to these rights and the purchase price provided for therein were substantially the same. However, when the rights were issued to the shareholders, and when they were later exercised by them, the value of the stock was in excess of the purchase price. One of the principal questions considered in the *Palmer* case was whether the issuance of the rights constituted a distribution of a dividend, as the Commissioner had there determined.

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<sup>9</sup>The *Palmer* case did not deal with a spinoff situation such as is involved in this case.

The Court, in language which is unmistakable, held:

“*First.* The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. Cf. *Miles v. Safe Deposit & T. Co.*, 259 U.S. 247; *Helvering v. San Joaquin Co.*, 297 U.S. 496; *Helvering v. Bartlett*,<sup>10</sup> *supra*. They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise. The question, then, is whether the distribution which results from the exercise of the rights must be regarded as a dividend \* \* \*” (302 U.S. 71).

Petitioner’s seeming notion in the case at bar that there was a “profit” realized from the disposition of the rights (Pet. Br. 8, 16) simply will not square with the decision of the Supreme Court in the *Palmer* case. As the Supreme Court made crystal clear, the rights issued by Pacific to its shareholders were not dividends, but merely *offers* to them to purchase Northwest stock. The sole purpose and effect of the rights, which expired by their terms after about three weeks, was to act as a vehicle for the transfer of the Northwest stock to the Pacific shareholders, conditioned upon the payment of cash. The issuance of the

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<sup>10</sup>In *Bartlett* (71 F.2d 598) the court held that when rights were exercised they were extinguished and merged into the stock purchased in exercise of the rights.

rights by Pacific did not effect any distribution of property by Pacific to its shareholders. A distribution of Pacific's property could take place only on exercise of the rights. On such exercise, the rights were extinguished, and the property distributed by Pacific to its shareholders consisted of Northwest stock. It is the Northwest stock that the Commissioner has determined to be the subject of the distribution as a taxable dividend, both in his rulings and in the determination of the deficiency in this case.

The Tax Court properly applied the *Palmer* case, and held that the issuance of rights in this case may not be considered as a distribution of corporate earnings and profits. The Tax Court stated as follows (I-R. 118):

“If any income is to be charged to [taxpayers] it must be regarded as stemming from the exercise of the rights, by obtaining the Northwest stock for a consideration less than its fair market value. But Section 355 was intended to permit the receipt of such stock without tax even where the recipient paid nothing therefor, and we think it would be a distortion of Congressional purpose to impute an intention to impose the tax where the recipient was required in effect to contribute to the capital of the distributing corporation as a condition to receiving the distributed stock.”

The Tax Court carefully considered all of the conditions prescribed in section 355 and found that they were fully satisfied. It further held, pursuant to section 355, that no gain or includible income must be recognized in respect of the Northwest stock received by taxpayers, and therefore, that the Commissioner erred in determining that

taxpayers received any dividend income. The Tax Court found it unnecessary to pass on the alternative contentions made by taxpayers that they received no dividend income by reason of other sections of Subchapter C of the Code (I-R. 111).

It remains only to examine the specific objections raised by petitioner that various requirements of section 355 have not been met. These objections are set out in headings C, D, E and F of petitioner's brief on pages 19 through 30, inclusive. Taxpayers will discuss these objections in the order in which they are set forth in petitioner's brief, and demonstrate that they are without merit.

**A. Pacific "distributed" Northwest stock to taxpayers "with respect to its stock," as required by section 355(a)(1)(A).**

In contending that the conditions of section 355(a)(1)(A) (App. v) are not met, petitioner focuses on certain words and phrases in that subsection. The essence of petitioner's contentions in this regard is set out as follows (Pet. Br. 20):

"In this case, Pacific did not 'distribute' Northwest stock 'with respect to its stock.' Rather, it sold Northwest stock having a market value of \$26 for six stock rights and \$16. The only thing Pacific distributed 'with respect to its stock' were stock rights, and such rights are not 'stock or securities,' but only options to purchase stock."

These assertions are a restatement of petitioner's erroneous theory that the subject of the distribution here in question was the stock rights rather than the Northwest

stock received by taxpayers on the exercise of their rights.<sup>11</sup>

In making his contentions under section 355(a)(1)(A), petitioner purports to give that language a literal reading by making a distinction between a “distribution” and what petitioner terms a “sale.” The Tax Court held that the Northwest stock was “literally distributed” to petitioners (I-R. 117). Petitioner finds this statement of the court “astonishing” and “completely unfounded” (Pet. Br. 20). On the contrary, the Tax Court’s conclusion is squarely in accord with the decision of the Supreme Court in the *Palmer* case. There, the Supreme Court stated as follows (302 U.S. 69):

*“While a sale of corporate assets to stockholders is, in a literal sense, a distribution of its property, such a transaction does not necessarily fall within the statutory definition of a dividend. For a sale to stockholders may not result in diminution of its net worth and in that case cannot result in any distribution of its profits”* (emphasis added).

Not only is petitioner in error in asserting that the term “distribution” precludes a transfer for a consideration, but it may clearly embrace, as the Supreme Court has said in the *Palmer* case, a transfer for a cash consideration, i.e., what petitioner refers to as a sale. The Tax Court thus correctly held that there was literally a distribution of the Northwest stock. This conclusion, as has

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<sup>11</sup>As the Tax Court properly noted, if the subject of the distribution was the Northwest stock rather than the rights, it is unnecessary to consider whether stock rights constitute securities within the meaning of section 355(a)(1)(A) (I-R. 116, n. 7).

been noted above, is in accordance with the Commissioner's own ruling.

Petitioner next contends that whatever meaning may be attached to the word "distribute," standing alone or in a different context, the phrase "distribution with respect to stock" is always used to refer to distributions *without* consideration, not sales (Pet. Br. 21). First of all should be noted the contradiction between this contention and the petitioner's determination of the deficiency in this case. Petitioner has determined that the taxpayers received a distribution from Pacific which is taxable as a dividend under section 301 (App. i-iii). How can it be said that taxpayers received a distribution taxable as a dividend and not, as petitioner asserts, a distribution with respect to their Pacific stock? There can be no dividend income except "with respect to stock," since only a stockholder can receive a distribution taxable as a dividend under section 301. As the owners of 600 shares of common stock of Pacific, taxpayers received 600 rights. As shareholders of Pacific, they exercised all of said rights, and thereby received shares of Northwest stock. To state, as petitioner contends, that taxpayers at one and the same time received a distribution which is taxable as a dividend, and did not receive such distribution with respect to their Pacific stock, is a self-contradiction.

Petitioner attempts to resolve the above contradiction by stating that a dividend is not limited to distributions with respect to stock, but may include transactions other than a distribution with respect to stock (Pet. Br. 21, n. 6). No authority is cited for this startling proposition other than a reference to section 316, which sets forth

the definition of a dividend. It is apparent that this section must be read in conjunction with section 301 (App. i-iii), which expressly provides that a taxable dividend thereunder is a distribution "made by a corporation to a shareholder with respect to its stock" (sec. 301(a); see sec. 301(c)(1)). In determining that the taxpayers received taxable dividend income under section 301, the Commissioner necessarily has determined that taxpayers received the Northwest stock with respect to their Pacific stock.

The context of section 355 reveals that the term "distributes . . . with respect to stock" was intended to be used in its broadest sense. The term "distributes" appears under (i) of section 355(a)(1)(A) (App. v), and likewise under (ii) of that section. As used in (ii), the term "distributes" clearly refers to transfers by a corporation for a consideration, for it obviously contemplates exchanges by the distributing corporation of stock or securities of the controlled corporation for its own securities, i.e., its obligations. There is nothing to suggest that the term "distributes" under (i) has a more limited meaning and refers to transfers of corporate property to shareholders without consideration.

Section 355 contemplates and expressly provides for distributions with or without surrender of stock by shareholders, and whether or not pro rata for all of the shareholders (sec. 355(a)(2) (App. vii)). Thus, a transfer of stock of a controlled corporation to preferred stockholders in exchange for their preferred stock could clearly qualify under section 355(a)(1)(A)(i) as a distribution by a

corporation to a shareholder with respect to its stock. It is apparent that distributions with respect to stock necessarily include distributions for a consideration.

Petitioner asserts, however, that wherever this phrase is used in the Code, it never means distributions for a *cash* consideration (Pet. Br. 20-21). On the contrary, the Commissioner's own regulations at section 1.301-1(j) and (k) (App. xiii-xiv) provide that a transfer of property by a corporation to its shareholders in exchange for cash can involve a distribution of property with respect to its stock, and can result in a dividend unless one of the non-recognition provisions of the Code applies. The regulations referred to deal with so-called bargain purchases of corporate property by a shareholder. Under these regulations, an individual shareholder who is permitted to purchase corporate property for less than its fair market value is considered to have received a taxable distribution equal to the bargain element in his purchase. This is the theory on which the Commissioner has relied in holding that the purchase by taxpayers of the Northwest stock for less than its fair market value resulted in the distribution of a taxable dividend. The court below properly ruled that there was a distribution with respect to the Pacific stock, but that section 355 applied to this distribution, so that no taxable income resulted therefrom.

Petitioner adverts to the use of the term "solely" in section 355(a)(1)(A) and asserts that the "sole consideration permitted by section 355 is an exchange of stock or securities" (Pet. Br. 21). This statement would be correct if petitioner had stated that the sole considera-

tion *permitted to be received tax free* by section 355 is stock or securities. Section 355 like other comparable non-recognition provisions in this part of the Code does not preclude the *payment* of cash by a tax-free distributee. This is manifest when section 355 is examined in relation to its companion sections 354 and 356 (App. iv-v, ix-xii). Section 356 provides that where tax-free distributions or exchanges under sections 354 or 355 involve the receipt of stock or securities permitted to be received without the recognition of gain, and *also* of other property or money, gain is to be recognized to the extent of the money or such other property *received*. The authorities are too numerous to cite that where, under section 354 and its predecessor sections, the recipient of stock or securities *paid* money, nonrecognition of gain would still remain for the stock or securities received (e.g., *Securities Co. v. Commissioner of Internal Revenue* (2 Cir. 1933) 64 F.2d 330; *Robert Dollar Co.* (1952) 18 T.C. 444, acquiescence). The same is true with respect to the parallel provisions of section 355. Under that section where only stock or securities have been received, with cash *paid*, so too the statute expressly permits the stock or securities to be received without the recognition of gain.

In situations where section 355 would apply but for the receipt of cash or other property, the manifest intent of Congress was to limit the recognition of gain to the amount of such cash or other property *received* (sec. 356). It is inconceivable that Congress could have intended, in a transaction whereunder the Pacific shareholders received Northwest stock and paid money to Pacific, that such payment should occasion a tax on the receipt of their

Northwest stock. The purpose of the offering of the Northwest stock to the Pacific shareholders was to permit them on the exercise of their rights to have the same ownership of Northwest after such exercise as they had in the business and properties transferred by Pacific to Northwest before the plan for reorganization was carried out. After the taxpayers exercised the rights issued to them, they owned precisely the same equity interest in the business and property of Pacific and Northwest as they had in Pacific before the plan was carried out. In addition, taxpayers paid into Pacific in cash \$16 for each and every share of Northwest received by them.

As petitioner's brief states, it is beyond argument that the fundamental basis of nonrecognition of gain or loss under section 355 is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization (Pet. Br. 24). This is precisely what occurred here. There was a readjustment of corporate ownership involving the division of the assets and businesses of Pacific between those in California and those in the States of Oregon, Washington and Idaho. Such readjustments were intended by Congress to be permitted under section 355 as long as the interests of the shareholders remained in corporate solution. In the division of the assets and businesses of Pacific through the plan of reorganization, taxpayers received nothing other than the Northwest stock. Section 355 literally requires that the receipt of this stock be treated as tax free. Certainly it would take the most positive language in section 355 to impose a tax merely because cash had been paid in by the shareholders of Pacific, when

admittedly without such payment section 355 would have permitted them to receive the Northwest stock tax free. No such language and no such intent can be found in section 355.

**B. Distribution by Pacific of all of the stock of Northwest satisfied the transfer of control requirement of section 355(a)(1)(D).**

Petitioner asserts that the provisions of section 355(a)(1)(D) (App. vi) are not satisfied, since Pacific did not distribute, with respect to its stock, control of Northwest. Control is defined as the ownership of at least 80 per cent of the voting stock and 80 per cent of all other stock of the corporation (Pet. Br. 23). Under this portion of his argument, petitioner reserves for later discussion the point that 57 per cent of the stock of Northwest was transferred in 1961, and the remainder transferred in 1963. As petitioner states, this argument is a mere re-statement of his contentions discussed by taxpayers under heading A of this brief (Pet. Br. 23). It reflects petitioner's groping for a rationalization of his position that Congress intended to preclude the application of section 355 in a situation where stock of a controlled corporation is transferred to shareholders who paid cash into the distributing corporation.

Petitioner asserts that "the issuance of transferable stock rights, the exercise of which requires substantial cash payments by the shareholders, predictably will diminish the continuity of ownership" (Pet. Br. 24). It should be noted first that there was no substantial diminution of continuity of ownership present here. When the plan of reorganization was completed more than 95

per cent of the stock of Northwest was owned by the same Pacific shareholders to whom the rights to acquire Northwest stock were distributed (I-R. 125, n. 10). Petitioner alleges that section 355 was designed to minimize the risk that shareholders of a distributing corporation would receive shares of a controlled corporation which they might turn around and sell, and thereby privately "cash in" on the distributing corporation's earnings and profits (Pet. Br. 24). But the provisions designed to prevent this method of tax avoidance are contained in an entirely different subsection of section 355, namely, section 355(a)(1)(B) (App. vi). Section 355(a)(1)(B) provides that the transaction involving a distribution of the stock of a controlled corporation may not be used as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation, or both. Congress expressly recognized that, subsequent to the distribution, the stock of the controlled corporation might be sold or exchanged by all or some of the distributees. It was expressly provided that such fact alone should not be construed to mean the transaction was principally used as such a device (sec. 355(a)(1)(B)). No question of such a "device" is present here. It is undisputed that the plan of reorganization and the transfer of the Northwest stock to the Pacific shareholders fulfilled sound business purposes of Pacific, and were not in any way intended or used as a device for the distribution of earnings and profits.

With respect to section 355(a)(1)(D), Congress plainly required that there be continuity of interest as between the shareholders or security holders of the distributing

corporation and the controlled corporation, but this was required only to the extent of 80 per cent of the stock of the controlled corporation. Here, there was continuity of interest represented by 95 per cent of the stock of Northwest. There is thus present the fundamental basis for nonrecognition of gain or loss under section 355 which petitioner espouses (Pet. Br. 24). Petitioner states that the fundamental basis for nonrecognition under that section "is that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization." No more inappropriate occasion for recognition of a gain could be found than here, where taxpayers exercised their rights and acquired Northwest stock to maintain precisely the same corporate interest after the reorganization as they possessed before. Far from *receiving* any benefit in the form of cash or other property, which might provide an appropriate occasion for the imposition of a tax, taxpayers *paid out* money.

As the Tax Court pointed out, Pacific disposed of every share of Northwest, retaining none whatever, thereby satisfying the underlying objective of section 355(a)(1)(D) (I-R. 124-125). The court further noted that the fact that some shares were transferred to purchasers of rights, rather than to stockholders, was immaterial, for in any event more than 80 per cent of the shares of Northwest were transferred to Pacific shareholders. Section 355(a)(1)(D) was therefore fully satisfied.

**C. Section 355(a)(1)(D) does not require a single distribution of control of Northwest, as petitioner contends.**

Petitioner contends that the requirement of section 355(a)(1)(D) (App. vi) relating to the distribution of all or at least 80 per cent of the stock of Northwest is not satisfied (Pet. Br. 25-27). His position in this regard is variously stated as follows: (1) that section 355(a)(1)(D) requires “a single distribution” (Pet. Br. 25); (2) that “the date of distribution is a pivotal moment in time” (Pet. Br. 26); and (3) that the single distribution must occur “at a fixed point in time” (Pet. Br. 27). Petitioner asserts that any other interpretation of section 355(a)(1)(D) would make its operation “administratively unworkable” (Pet. Br. 25).

At the outset it should be observed, as petitioner admits, that this argument is made for the first time on review by this Court (Pet. Br. 26, n. 8). Ignoring any question as to whether petitioner is precluded from urging this contention before this Court, it must clearly be rejected as without merit. Petitioner’s reliance is on a purported literal reading of the statute involving isolated words and phrases in section 355 and attributing to them a meaning without regard to their context. Petitioner seizes on the use of the singular in referring to “the date of distribution,” and insists that the use of the phrases “immediately before” and “immediately after” a distribution requires a single transfer of control in the distribution of the stock of the controlled corporation at a fixed point in time (Pet. Br. 25-26).

Petitioner can derive no comfort from the use of the singular in the statutory reference to “the distribution”

or “the date of distribution.” The statute likewise refers to “a shareholder” in section 355(a)(1)(A)(i) (App. v), and certainly it would be inconceivable that the use of the singular therein required that its operative effect be limited to transactions involving a single shareholder. The short answer to all of this is that section 1 of Title 1 of the United States Code provides that, unless the context indicates otherwise, words importing the singular include and apply to the plural. Nothing in the context of section 355 requires a fixing of a single date for the distribution of control.

Petitioner seeks to support his argument by references to the language “immediately before” and “immediately after” as connoting a requirement for a single transfer. This language was obviously borrowed from and parallels the language “immediately after” in section 351 (App. iii-iv) and its predecessor provisions. The language of section 351 has been uniformly considered to admit of a number of transfers. Section 351 has never been considered as requiring a single transfer (*Halliburton v. Commissioner of Internal Revenue* (9 Cir. 1935) 78 F.2d 265; *Portland Oil Co. v. Commissioner of Internal Revenue* (1 Cir. 1940) 109 F.2d 479, certiorari denied (1940) 310 U.S. 650). The Treasury regulations interpreting section 351, which have been substantially unchanged since the regulations under the Revenue Act of 1934, provide as follows:

“The phrase ‘immediately after the exchange’ does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds

with an expedition consistent with orderly procedure” (Income Tax Regs. sec. 1.351-1(a)(1)).

Far from supporting the novel position adopted by the petitioner, the use of this language clearly requires rejection of petitioner’s contention.

Section 355 is a part of the subchapter of the Code which deals with corporate reorganizations. In fact, transactions to which section 355 is applicable may well involve reorganizations under section 368. Section 355(a)(2)(C) (App. vii) provides that section 355 may be applied whether or not the distribution is in pursuance of a plan of reorganization under section 368. Section 355 was intended to deal in one section with the subject matter of corporate reorganizations in the form of spinoffs, split-offs and split-ups (S.Rept. 1622, 83d Cong., 2d Sess., 266). Congress was well aware of the operation of the reorganization provisions contained in Subchapter C. These provisions have long been construed so as to permit the treatment of various steps in consummating plans of reorganization as part of a single transaction (3 Mertens, Law of Federal Income Taxation, sec. 20.161 et seq., and cases there cited). The Commissioner himself has ruled that the step transaction doctrine, generally applicable in the case of reorganizations under section 368, applies under section 355 (Rev. Rul. 57-311, C.B. 1957-2, 243).

Not only is there no basis in the language of section 355 to support the contention that the distribution of control required under section 355(a)(1)(D) must be effected on or as of a single day, but there is no warrant for the assertion that any other construction would make

the statute administratively unworkable. On the contrary, the strained manner in which petitioner seeks to limit the operation of section 355 would make it virtually unworkable for corporations having a large number of shareholders. This may be illustrated by what transpired in carrying out the plan of reorganization by Pacific. Pacific had over 38,000 shareholders. Its stock was listed on the New York Stock Exchange and the Pacific Coast Stock Exchange. The Northwest stock was listed on the American Stock Exchange and on the Pacific Coast Stock Exchange. The consummation of the plan of reorganization of Pacific was quite complex. It involved the formulation of the plan, its presentation to the directors and shareholders, approvals by state and Federal regulatory agencies, the filing of registration statements with the Securities and Exchange Commission, the listing of securities on the various Exchanges, and the complicated corporate and financial matters involved in the issuance of the very large amounts of stock of Northwest and the receipt of large amounts of capital. When these transactions were completed, Pacific distributed 30,460,000 shares of Northwest and received \$487,360,000.

It is undisputed that the transactions involving the initial distribution of the Northwest stock in 1961 and the distribution of the Northwest stock in 1963 were inter-related, interdependent and justifiably occurring within the period of two years as contemplated by the plan (Pet. Br. 25-26). Petitioner finds it difficult to comprehend that "the state of mind of those in control of the distributing corporation should have the effect of transforming two distributions into one" (Pet. Br. 26). It is

not merely an intent that is controlling in requiring that the two transfers of the Northwest stock be viewed as parts of a single transaction, but rather the fact that they were contemplated and required by the plan of reorganization pursuant to which the Northwest shares were distributed. It is submitted that unless corporations could have some leeway in the timing of exchanges and distributions of stock or securities of a controlled corporation under section 355, that section would be virtually useless in carrying out readjustments of corporate and stockholder relationships as contemplated by section 355 in the case of corporations of any magnitude. It should be noted that section 355 embraces distributions not only to shareholders but also to all other security holders and also prorata or non-prorata distributions and exchanges, with or without the surrender of stock. It is inconceivable that, with such latitude allowed corporations in the manner of effecting corporate readjustments under section 355, Congress would have required that they take place as of a single day. No rational basis can be found for any such limitation. None is expressed in any of the committee reports dealing with section 355.

Under the reorganization provisions elsewhere in Subchapter C, in which section 355 appears, tax-free reorganization plans have been allowed to be carried out over a period of time. Such time intervals in effecting tax-free reorganizations have not involved any unworkable administrative difficulties that petitioner professes to see if several distributions were treated under section 355 as part of a single transaction. There is present here no administrative difficulty in determining that the require-

ments of section 355(a)(1)(D) are fully satisfied, as held by the Tax Court. Both immediately before and immediately after the distributions, both Pacific and Northwest were engaged in active businesses (sec. 355(b)(1)(A)). The business of Northwest had been conducted for a period of five years ending on the date of distribution (sec. 355(b)(2)(B)). Obviously, the business of Northwest, like that of Pacific, was actively continued both long before and long after the plan of reorganization was begun and completed. The Tax Court properly held that the disposition by Pacific of every share of Northwest, retaining none whatever, carried out the underlying objective of section 355(a)(1)(D) (I-R. 124-125).

**D. When Northwest acquired its telephone businesses from Pacific in exchange for stock and a demand note, no gain was recognized in whole or in part within the meaning of section 355(b)(2)(C).**

The last objection made by the petitioner to the application of section 355 to the transactions here in question involves section 355(b)(2)(C) (App. ix). That section imposes a limitation on the acquisition by the controlled corporation of the business which is the subject of the section 355 distribution. The limitation here in question, which petitioner contends is not satisfied, is that the business of the controlled corporation *not* be acquired in a transaction "in which gain or loss was recognized, in whole or in part." This restriction is related to the so-called five-year active business rule, and requires that an active business be conducted for a period of five years either by the controlled corporation, Northwest, or by its predecessor corporation, Pacific. If the latter, the business must

have been transferred from Pacific to Northwest in a tax-free transaction.

The burden of petitioner's argument is that the telephone businesses in the States of Washington, Oregon and Idaho were acquired by Northwest in a transaction to which section 351 (App. iii-iv) applies, and, that under said section, gain would have been required to be recognized by Pacific in part, to the extent of the \$200 million demand note received by Pacific. Petitioner contends that the \$200 million note received by Pacific from Northwest was not a security within the meaning of section 351, which could have been received by Pacific tax free (Pet. Br. 28).

The Tax Court found it unnecessary to determine whether or not the demand note was a security for purposes of section 351 (I-R. 121). The Tax Court held that the nonrecognition requirements of section 355(b)(2)(C) were satisfied by reason of the fact that the transfer by Pacific of the assets to Northwest was an intercompany transaction between affiliated corporations included in the consolidated income tax return filed by American, and that therefore no taxable gain resulted therefrom (I-R. 121). Petitioner does not dispute that whatever gain Pacific might have had on the transfer of the assets to Northwest was properly eliminated and not taxable under the consolidated return provisions and regulations thereunder (Pet. Br. 29). Petitioner insists, however, that a distinction must be made between nonrecognition of gain by reason of the filing of a consolidated income tax return and nonrecognition of gain under provisions of Subchapter C, and contends that only the latter type of

nonrecognition satisfies the requirement of section 355 (b)(2)(C) (Pet. Br. 29).

Petitioner states that the Tax Court “apparently never considered” what intelligible legislative purpose would be served by making qualification under section 355 depend upon the happenstance that an affiliated group of corporations subsequently elected to file a consolidated income tax return (Pet. Br. 29).

First of all, it should be noted that there was no election made in 1961 for the filing of a consolidated income tax return. Corporations which had filed consolidated income tax returns for 1960 were not permitted to make a new election for 1961 (Income Tax Regs. sec. 1.1502-11). Since American had filed a consolidated income tax return for the year 1960, it was required to, and did, file a consolidated income tax return for the year 1961. This fact alone casts serious doubt upon petitioner’s argument that the character of the transaction must for purposes of section 355(b)(2)(C) be examined as of the date on which it occurs, and that a subsequent option may not relate back to change the character of the transaction (Pet. Br. 29-30).

More important, however, is the fact that the Tax Court did set forth a rational basis for its interpretation of the statute, and one which is clearly supported by its legislative history. It should be noted that no rational basis has been urged by petitioner for contending that hypothetical nonrecognition of gain under section 351 will satisfy the statute, but that actual nonrecognition of gain under other provisions of the Code will not. Certainly no

language can be pointed to by petitioner which so limits the nonrecognition provisions of section 355(b)(2)(C).

The purpose of section 355(b)(2)(C) was to provide a further safeguard against the use of section 355 as a means of distributing earnings and profits. As the Tax Court well stated, and as amply demonstrated by the committee reports (S.Rept. 1622, 83d Cong., 2d Sess., pp. 267-268), Congress was concerned that a going business with liquid assets might be purchased for the purpose of providing a medium through which a tax-free distribution of a corporation's earnings and profits could be effected (I-R. 120; see Cohen, Silverman, Surrey, Tarleau and Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 *Harvard Law Review*, 1954-1955, 393, 432). As the Tax Court stated, no such circumstances are present here. This case involves the operation of businesses conducted for many years by Pacific. The legislative purpose of section 355(b)(2)(C) is clearly served by permitting the businesses of Pacific in the States of Oregon, Washington and Idaho to be the subject of a tax-free divisive reorganization.

**E. In any event, even if nonrecognition of gain on the transfer of assets to Northwest is required under section 351, the demand note of Northwest was a security permitted to be received tax free by Pacific under that section.**

To support his contention that section 355(b)(2)(C) (App. ix) is not complied with, petitioner must be correct in his assertion that the required nonrecognition of gain on the transfer of the assets to Northwest must fall under section 351 (App. iii-iv) or some other section of Sub-

chapter C, and may not come under the consolidated return provisions. In addition, petitioner must demonstrate that gain would have been recognized to Pacific on such transfer under section 351. Petitioner claims that such a hypothetical gain would have resulted under section 351 because of the receipt of the \$200 million demand note by Pacific as part of the consideration for the transfer of the assets and business to Northwest.

Petitioner asserts that the \$200 million demand note was not a security within the meaning of section 351(a) (App. iii-iv), which could have been received tax free by Pacific under section 351. The statement is made that corporate notes qualify as securities "only when they are of sufficient duration to represent a substantial continuing interest in the corporation" (Pet. Br. 28, n. 9). This test is, of course, addressed to the character of the corporate indebtedness. Its application does not require that Pacific continue to own the note indefinitely. Rather, the test is whether the indebtedness of Northwest evidenced by the demand note represented part of its permanent capital—as petitioner puts it, "a substantial continuing interest in Northwest." The fact that the debt was in form payable on demand is not controlling. The cases clearly establish that the mere form of indebtedness does not control its status for tax purposes. This is clear from the cases involving so-called "thin corporations" where open account indebtedness or short-term notes may be treated as stock (*Gilbert v. C.I.R.* (2 Cir. 1959) 262 F.2d 512, cert. den. (1959) 359 U.S. 1002 (on appeal from remand of (2 Cir. 1957) 248 F.2d 399); *O. H. Kruse Grain & Milling v. C.I.R.* (9 Cir. 1960) 279 F.2d 123).

Here, the facts show that the \$200 million indebtedness, evidenced by the demand note received by Pacific, represented part of the permanent capital of Northwest (Exh. 17-Q, pp. 10, 12). The Tax Court found that this indebtedness was included in the liabilities of Northwest when Northwest was organized and was designed to establish Northwest with the same proportions of total debt and stock as those of Pacific prior to the transfer (I-R. 97). If Northwest had included the amount of the \$200 million note in the indebtedness of Pacific assumed by Northwest, clearly no gain would have been recognizable to Pacific under section 351. Had Pacific received long-term debentures from Northwest in the same amount as the demand note and had Pacific sold these debentures to the public, likewise, no gain would have been recognized to Pacific under section 351 on the receipt of such long-term debentures from Northwest. The same result should follow here where there was no intention or expectation that Northwest would reduce its capital on the payment of the note held by Pacific. Northwest and Pacific contemplated, as was done, that Northwest would refund the demand note by the issuance of long-term debentures. For this purpose Northwest issued to the public 20-year debentures in the amounts of \$50 million each during the period from 1961 to 1963, the proceeds of which were used in payment of the demand note held by Pacific (I-R. 63).

On these facts, it should be held that the demand note was part of the permanent capital of Northwest, and therefore constitutes a security within the meaning of section 351. If this point must be resolved in order to de-

cide this case, and this Court should for any reason feel that the findings of the Tax Court are not sufficient to require the treatment of the demand note as a security within the provisions of section 351, then the case should be remanded by this Court to the Tax Court for specific findings as to whether or not the demand note constituted a security (*Turner Construction Company v. United States* (2 Cir. 1966) 364 F.2d 525). The Tax Court, as has been pointed out, found it unnecessary to so determine, and should be given an opportunity to do so, if a decision on this point is necessary to decide this case.

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## II

IF FOR ANY REASON THIS COURT SHOULD HOLD THAT SECTION 355 IS NOT APPLICABLE TO THE FACTS OF THIS CASE, THIS CASE SHOULD BE REMANDED TO THE TAX COURT FOR CONSIDERATION OF THE ALTERNATIVE CONTENTIONS OF TAXPAYERS THAT THE COMMISSIONER'S DETERMINATION IS ERRONEOUS.

In addition to contending that section 355 applied to preclude the treatment of the receipt by taxpayers of the Northwest stock as a taxable dividend, taxpayers in the Tax Court relied on other provisions of the 1954 Code. Taxpayers in the court below contended, in the alternative, that no gain should be recognized by taxpayers on the receipt of the Northwest stock by reason of the provisions of section 354, involving exchanges of stock and securities in reorganizations. A further alternative contention made by taxpayers was that if any gain is to be recognized on the receipt of the Northwest stock by taxpayers, such gain must be treated as a capital gain by reason of the

provisions of section 346(b), dealing with distributions in partial liquidation (I-R. 110-111).

If this Court should for any reason hold that section 355 is not applicable and that the receipt of the Northwest stock was not tax free thereby, the case should be remanded for consideration by the Tax Court of these alternative contentions of the taxpayers based on the other provisions of the Code (Pet. Br. 30).

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### SUMMARY OF ARGUMENT

For sound corporate business reasons, Pacific formulated a plan for the separation of the business and assets of Pacific in the three States of Washington, Oregon and Idaho into a new corporation, Northwest, to have a separate management and to be owned by the Pacific shareholders. Pacific was advised by its attorneys that it was not possible under the California corporation law to distribute the stock of Northwest to its shareholders pro rata out of its capital or surplus. Petitioner concedes that had Pacific transferred its assets, in the three states referred to, to Northwest for its common stock and had it distributed such stock to its shareholders, there would have occurred, in the language of the Tax Court, "a classic case of a tax-free divisive reorganization," or spinoff, to which section 355 (App. v-ix) was clearly addressed. The only factor present here not present in the classic tax-free spinoff case was that the distribution of the Northwest stock was conditioned upon payment of \$16 a share by Pacific shareholders to Pacific. Such cash pay-

ment served the additional purpose of providing needed capital for Pacific's operations in California. If section 355 applies to the receipt of the Northwest stock by taxpayers, petitioner concedes that no amount is includible in their income on the receipt of the Northwest stock.

Petitioner's contentions that section 355 does not apply revolve around a basic misconception of the proper tax treatment of the rights issued by Pacific to its shareholders. Petitioner contends that the subject of the distribution by Pacific to its shareholders under the plan of reorganization was the rights to subscribe to the Northwest stock, rather than the Northwest stock itself. The Tax Court properly held, in accordance with the Supreme Court's decision in *Palmer v. Commissioner* (1937) 302 U.S. 63, that the subject of the distribution by Pacific was not the rights but the Northwest stock. The court in the *Palmer* case held that the mere issuance of rights does not involve a distribution of corporate assets, since rights are options or continuing offers which result in distribution of the corporate property only on their exercise. The Tax Court properly held that the Northwest stock was distributed by Pacific and that section 355 applied to this distribution.

Petitioner is in error in his contention that the Northwest stock was not distributed by Pacific to Pacific shareholders, as required by section 355(a)(1)(A) (App. v). The phrase "distributes . . . with respect to stock" does not preclude a transfer for a consideration. It may clearly embrace, as the Supreme Court said in the *Palmer* case, a transfer for a cash consideration. When section 355 is examined in relation to its companion sections 354 and

356 (App. iii-iv, ix-xii), it is clear that gain is to be recognized only to the extent of cash or other property *received*, and not where solely stock or securities have been received, with cash *paid*. There is present here, as petitioner states, the fundamental basis for nonrecognition of gain under section 355, namely, that no tax should be imposed when the same people continue to own the same businesses with only formal changes in the business organization. The Tax Court properly held that the distribution by Pacific of every share of Northwest, retaining none whatever, satisfied the underlying objective of section 355(a)(1)(D). Under this section, Congress plainly required that there be continuity of interest as between the shareholders of the distributing corporation and the controlled corporation only to the extent of 80 per cent of the stock of the controlled corporation. Here, there was continuity of interest represented by 95 per cent of the stock of Northwest.

Petitioner erroneously asserts that section 355(a)(1)(D) (App. vi) requires a single distribution of control of Northwest at a fixed point in time. Section 355 was intended to deal in one section with the subject matter of reorganizations in the form of spinoffs, split-ups and split-offs. The reorganization provisions in Subchapter C have long been construed so as to permit the treatment of various steps in consummating plans of reorganization as part of a single transaction. It is undisputed that the transactions involved in the initial distribution of the Northwest stock in 1961, and the distribution of the Northwest stock in 1963, were interrelated, interdependent and justifiably occurring within the period of two years, as

contemplated by the plan. There are no administrative difficulties in viewing these distributions as part of a single transaction which satisfied the distribution of control requirement in section 355(a)(1)(D).

There is no merit to petitioner's contention that the transfer of the business to Northwest did not satisfy the nonrecognition provisions of section 355(b)(2)(C) (App. ix). No taxable gain in fact resulted because the transfer was an intercompany transaction between affiliated corporations included in a consolidated income tax return filed by American. Petitioner concedes that no taxable gain resulted from the transfer. Petitioner contends, however, that such nonrecognition of gain does not satisfy the requirements of section 355(b)(2)(C), and that the transaction must qualify for nonrecognition under some provision of Subchapter C—in this case, section 351. The Tax Court properly ruled that actual nonrecognition of gain under any provisions of the Code satisfied the provisions of section 355(b)(2)(C). These provisions were designed to prevent the use of section 355 as a means of distributing earnings and profits through the purchase of a going business with liquid assets. No such circumstances are present here. The legislative purpose of section 355(b)(2)(C) is clearly served by permitting the businesses of Pacific in the States of Washington, Oregon and Idaho to be the subject of a tax-free divisive reorganization.

Even if nonrecognition of gain under section 351 is required on the transfer of the assets of Northwest, for purposes of section 355(b)(2)(C), the demand note of Northwest was a security permitted to be received tax

free by Pacific. This note represented a permanent part of Northwest's capital. It was refunded by the public offering by Northwest of 20-year debentures in the amount of \$50 million each.

The Tax Court deemed it unnecessary to make specific findings as to whether the \$200 million note qualified as a security for purposes of section 351. If this point must be resolved in order to decide this case, and the Court should for any reason feel that the findings of the Tax Court are not sufficient to require that the demand note be treated as a security, then the case should be remanded to the Tax Court for further findings.

Taxpayers have made alternative contentions that no gain or loss was recognized on the receipt of Northwest stock because of the application of section 354, involving exchanges of stock or securities in reorganizations. A further alternative contention was made that if gain was to be recognized to the taxpayers on the receipt of the Northwest stock, such gain should not be treated as dividend income but as capital gain under the provisions of section 346(b), dealing with distributions by corporations in partial liquidation. The Tax Court found it unnecessary to pass on these alternative contentions because it held that the receipt of the Northwest stock was tax free under section 355. If this Court should hold that section 355 is not applicable, the case should be remanded for consideration by the Tax Court of these alternative contentions.

**CONCLUSION**

For the reasons stated herein, this Court should hold that section 355 applies to the receipt of the Northwest stock by taxpayers, and the decision of the Tax Court should be affirmed. If this Court should hold that section 355 is not applicable, the case should be remanded to the Tax Court for consideration of the alternative contentions of taxpayers based on other provisions of the Code.

Respectfully submitted,

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November 8, 1966.

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**CERTIFICATE**

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: November 8, 1966.

HARRY R. HORROW.

**(Appendix Follows)**



## **Appendix**



## Appendix

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### Internal Revenue Code of 1954:

#### SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) AMOUNT DISTRIBUTED.—

(1) GENERAL RULE.—For purposes of this section, the amount of any distribution shall be—

(A) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) CORPORATE DISTRIBUTEES.—If the shareholder is a corporation, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311, under section 341(f), or under section 1245(a) or 1250(a).

(C) CERTAIN CORPORATE DISTRIBUTEES OF FOREIGN CORPORATION.—Notwithstanding subparagraph (B), if the shareholder is a corporation and the distributing corporation is a foreign corporation, the amount taken into account with respect to property (other than money) shall be the fair market value of such property; except that if any deduction is allowable under section 245 with respect to such distribution, then the amount taken into account shall be the sum (determined under regulations prescribed by the Secretary or his delegate) of—

(i) the proportion of the adjusted basis of such property (or, if lower, its fair market value) properly attributable to gross income from sources within the United States, and

(ii) the proportion of the fair market value of such property properly attributable to gross income from sources without the United States.

(2) REDUCTION FOR LIABILITIES.—The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by—

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) DETERMINATION OF FAIR MARKET VALUE.—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) **AMOUNT TAXABLE.**—In the case of a distribution to which subsection (a) applies—

(1) **AMOUNT CONSTITUTING DIVIDEND.**—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) **AMOUNT APPLIED AGAINST BASIS.**—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) **AMOUNT IN EXCESS OF BASIS.**—

(A) **IN GENERAL.**—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) **DISTRIBUTIONS OUT OF INCREASE IN VALUE ACCRUED BEFORE MARCH 1, 1913.**—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

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# **SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.**

(a) **GENERAL RULE.**—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange

such person or persons are in control (as defined in section 368 (c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) RECEIPT OF PROPERTY.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) SPECIAL RULE.—In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

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#### SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securi-

ties in such corporation or in another corporation a party to the reorganization.

(2) **LIMITATION.**—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(3) **CROSS REFERENCE.**—

For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

\* \* \* \* \*

## **SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.**

(a) **EFFECT ON DISTRIBUTEES.**—

(1) **GENERAL RULE.**—If—

(A) a corporation (referred to in this section as the “distributing corporation”)—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as “controlled corporation”) which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and it is established to the satisfaction of the Secretary or his delegate that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368 (a) (1) (D)).

(3) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1) (D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) CROSS REFERENCE.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

#### **SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.**

(a) **GAIN ON EXCHANGES.—**

(1) **RECOGNITION OF GAIN.—If—**

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354

or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) TREATMENT AS DIVIDEND.—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) ADDITIONAL CONSIDERATION RECEIVED IN CERTAIN DISTRIBUTIONS.—If—

(1) section 355 would apply to a distribution but for the fact that

(2) the property received in the distribution consists not only of property permitted by section 355 to be received without the recognition of gain, but also of other property or money,

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

(c) Loss.—If—

(1) section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that

(2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,

then no loss from the exchange or distribution shall be recognized.

(d) SECURITIES AS OTHER PROPERTY.—For purposes of this section—

(1) IN GENERAL.—Except as provided in paragraph (2), the term “other property” includes securities.

(2) EXCEPTIONS.—

(A) SECURITIES WITH RESPECT TO WHICH NON-RECOGNITION OF GAIN WOULD BE PERMITTED.—The term “other property” does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) GREATER PRINCIPAL AMOUNT IN SECTION 354 EXCHANGE.—If—

(i) in an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term “other property” means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C) GREATER PRINCIPAL AMOUNT IN SECTION 355 TRANSACTION.—If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term “other property” means only the fair market value of such excess.

(e) EXCHANGES FOR SECTION 306 STOCK.—Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as a distribution of property to which section 301 applies.

(f) TRANSACTIONS INVOLVING GIFT OR COMPENSATION.—For special rules for a transaction described in section 354, 355, or this section, but which—

(1) results in a gift, see section 2501 and following, or

(2) has the effect of the payment of compensation, see section 61(a)(1).

## Income Tax Regulations:

Sec. 1.301-1. Rules applicable with respect to distributions of money and other property.

\* \* \* \* \*

(j) *Transfers for less than fair market value.* If property is transferred by a corporation to a shareholder which is not a corporation for an amount less than its fair market value in a sale or exchange, such shareholder shall be treated as having received a distribution to which section 301 applies. In such case, the amount of the distribution shall be the difference between the amount paid for the property and its fair market value. If property is transferred in a sale or exchange by a corporation to a shareholder which is a corporation, for an amount less than its fair market value and also less than its adjusted basis, such shareholder shall be treated as having received a distribution to which section 301 applies, and—

(1) Where the fair market value of the property equals or exceeds its adjusted basis in the hands of the distributing corporation the amount of the distribution shall be the excess of the adjusted basis over the amount paid for the property;

(2) Where the fair market value of the property is less than its adjusted basis in the hands of the distributing corporation, the amount of the distribution shall be the excess of such fair market value over the amount paid for the property.

If property is transferred in a sale or exchange after December 31, 1962, by a foreign corporation to a shareholder which is a corporation for an amount less than the

amount which would have been computed under paragraph (n) of this section if such property had been received in a distribution to which section 301 applied, such shareholder shall be treated as having received a distribution to which section 301 applies, and the amount of the distribution shall be the excess of the amount which would have been computed under paragraph (n) of this section with respect to such property over the amount paid for the property. In all cases, the earnings and profits of the distributing corporation shall be decreased by the excess of the basis of the property in the hands of the distributing corporation over the amount received therefor. In computing gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of the distribution.

(k) *Application of rule respecting transfers for less than fair market value.* The application of paragraph (j) of this section may be illustrated by the following examples:

*Example (1).* On January 1, 1955, A, an individual shareholder of Corporation X, purchased property from that corporation for \$20. The fair market value of such property was \$100, and its basis in the hands of Corporation X was \$25. The amount of the distribution determined under section 301(b) is \$80. If A were a corporation, the amount of the distribution would be \$5, the excess of the basis of the property in the hands of Corporation X over the amount received therefor. The basis of such property to Corporation A would be \$25. If the basis of the property in the hands of Corporation X were

\$10, the corporate shareholder, A, would not receive a distribution. The basis of such property to Corporation A would be \$20. Whether or not A is a corporation, the excess of the amount paid over the basis of the property in the hands of Corporation X (\$20 over \$10) would be a taxable gain to Corporation X.

*Example (2).* On January 1, 1963, corporation A, which is a shareholder of corporation B (a foreign corporation engaged in business within the United States), purchased one share of corporation X stock from B for \$20. The fair market value of the share was \$100, and its adjusted basis in the hands of B was \$25. Assume that if the share of corporation X stock had been received by A in a distribution to which section 301 applied, the amount of the distribution under paragraph (n) of this section would have been \$55. The amount of the distribution under section 301 is \$35, i.e., \$55 (amount computed under paragraph (n) of this section) minus \$20 (amount paid for the property). The basis of such property to A is \$55.

\* \* \* \* \*

**Sec. 1.351-1. Transfer to corporation controlled by transferor.**

(a)(1) Section 351(a) provides, in general, for the non-recognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities in such corporation, if immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. As used in section 351, the phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies, or corporations (see

section 7701(a)(1)). To be in control of the transferee corporation, such person or persons must own immediately after the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation (see section 368(c)). In determining control under this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account. The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure. For purposes of this section—

(i) stock or securities issued for services rendered or to be rendered to or for the benefit of the issuing corporation will not be treated as having been issued in return for property, and

(ii) stock or securities issued for property which is of relatively small value in comparison to the value of the stock and securities already owned (or to be received for services) by the person who transferred such property, shall not be treated as having been issued in return for property if the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property. For the purpose of section 351, stock rights or stock warrants are not included in the term "stock or securities."

(2) The application of section 351(a) is illustrated by the following examples:

*Example (1).* C owns a patent right worth \$25,000 and D owns a manufacturing plant worth \$75,000. C and D organize the R Corporation with an authorized capital stock of \$100,000. C transfers his patent right to the R Corporation for \$25,000 of its stock and D transfers his plant to the new corporation for \$75,000 of its stock. No gain or loss to C or D is recognized.

*Example (2).* B owns certain real estate which cost him \$50,000 in 1930, but which has a fair market value of \$200,000 in 1955. He transfers the property to the N Corporation in 1955 for 78 percent of each class of stock of the corporation having a fair market value of \$200,000, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1940 to other persons for cash. B realized a taxable gain of \$150,000 on this transaction.

*Example (3).* E, an individual, owns property with a basis of \$10,000 but which has a fair market value of \$18,000. E also had rendered services valued at \$2,000 to Corporation F. Corporation F has outstanding 100 shares of common stock all of which are held by G. Corporation F issues 400 shares of its common stock (having a fair market value of \$20,000) to E in exchange for his property worth \$18,000 and in compensation for the services he has rendered worth \$2,000. Since immediately after the transaction, E owns 80 percent of the outstanding stock of Corporation F, no gain is recognized upon the exchange of the property for the stock. However, E realized \$2,000

of ordinary income as compensation for services rendered to Corporation F.

(b)(1) Where property is transferred to a corporation by two or more persons in exchange for stock or securities, as described in paragraph (a) of this section, it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts (section 2501 and following), to pay compensation (section 61(a)(1)), or to satisfy obligations of the transferor of any kind.

(2) The application of paragraph (b)(1) of this section may be illustrated as follows:

*Example (1).* Individuals A and B, father and son, organize a corporation with 100 shares of common stock to which A transfers property worth \$8,000 in exchange for 20 shares of stock, and B transfers property worth \$2,000 in exchange for 80 shares of stock. No gain or loss will be recognized under section 351. However, if it is determined that A in fact made a gift to B, such gift will be subject to tax under section 2501 and following. Similarly, if B had rendered services to A (such services having no relation to the assets transferred or to the business of the corporation) and the disproportion in the amount of stock

received constituted the payment of compensation by A to B, B will be taxable upon the fair market value of the 60 shares of stock received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

*Example (2).* Individuals C and D each transferred, to a newly organized corporation, property having a fair market value of \$4,500 in exchange for the issuance by the corporation of 45 shares of its capital stock to each transferor. At the same time, the corporation issued to E, an individual, 10 shares of its capital stock in payment for organizational and promotional services rendered by E for the benefit of the corporation. E transferred no property to the corporation. C and D were under no obligation to pay for E's services. No gain or loss is recognized to C or D. E received compensation taxable as ordinary income to the extent of the fair market value of the 10 shares of stock received by him.

### **Sec. 1.351-2. Receipt of property.**

(a) If an exchange would be within the provisions of section 351(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such subsection to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. No loss to the recipient shall be recognized.

(b) See section 357 and the regulations pertaining to that section for applicable rules as to the treatment of liabilities as “other property” in cases subject to section 351, where another party to the exchange assumes a liability, or acquires property subject to a liability.

(c) See sections 358 and 362 and the regulations pertaining to those sections for applicable rules with respect to the determination of the basis of stock, securities, or other property received in exchanges subject to section 351.

(d) See Part I (section 301 and following), subchapter C, chapter 1 of the Code, and the regulations thereunder for applicable rules with respect to the taxation of dividends where a distribution by a corporation of its stock or securities in connection with an exchange subject to section 351(a) has the effect of the distribution of a taxable dividend.

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**Sec. 1.355-1. Distribution of stock and securities of controlled corporation.**

(a) *Application of section.* Section 355 provides for the separation, without recognition of gain or loss to the shareholders and security holders, of two or more existing businesses formerly operated, directly or indirectly, by a single corporation. It applies only to the separation of existing businesses which have been in active operation for at least five years, and which, in general, have been owned for at least five years by the corporation making the distribution of stock or of stock and securities. Section 355 does not apply to the division of a single business.

For the purpose of section 355, stock rights or stock warrants are not included in the term 'stock and securities'.

(b) *Types of separations.* Section 355 is concerned with two general types of separations of businesses. The first is the distribution of the stock of an existing corporation. The second is the distribution of the stock of a new corporation which stock was received in exchange for the assets of a business previously operated by the distributing corporation. In both cases, this section contemplates the continued operation of the businesses existing prior to the separation.

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#### **Sec. 1.355-2. Limitations.**

(a) *Property distributed.* The property distributed must consist solely of stock or stock and securities of a controlled corporation. If additional property (including an excess principal amount of securities received over securities surrendered) is received, see section 356.

(b) *Distribution of earnings and profits.* (1) The transaction must not have been used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or of both. If, pursuant to an arrangement negotiated or agreed upon prior to the distribution of stock or securities of the controlled corporation, part or all of the stock or securities of either corporation are sold or exchanged after the distribution, such sale or exchange will be evidence that the transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corpo-

ration, or both. However, if the rules respecting continuity of interest contained in paragraph (c) of this section are not met, section 355 will not apply. If a sale of such stock or securities is made after the distribution and is not pursuant to an arrangement negotiated or agreed upon prior to the distribution, the mere fact of such sale is not determinative that the transaction was used principally as a device for the distribution of earnings and profits, but such fact will be evidence that the transaction was used principally as such a device.

(2) A sale is pursuant to an arrangement agreed upon prior to the distribution when enforceable rights to buy or to sell exist before such distribution. In any case in which a sale or exchange was discussed by the buyer and the seller before the distribution, but enforceable rights to buy or to sell did not exist before such distribution, the question whether an arrangement was negotiated within the meaning of section 355(a)(1)(B) shall be determined from all the facts and circumstances.

(3) In determining whether a transaction was used principally as a device for the distribution of the earnings and profits of the distributing corporation or of the controlled corporation or both, consideration will be given to all of the facts and circumstances of the transaction. In particular, consideration will be given to the nature, kind and amount of the assets of both corporations (and corporations controlled by them) immediately after the transaction. The fact that at the time of the transaction substantially all of the assets of each of the corporations involved are and have been used in the active conduct of trades or businesses which meet the requirements of sec-

tion 355(b) will be considered evidence that the transaction was not used principally as such a device.

(c) *Business purpose.* The distribution by a corporation of stock or securities of a controlled corporation to its shareholders with respect to its own stock or to its security holders in exchange for its own securities will not qualify under section 355 where carried out for purposes not germane to the business of the corporations. The principal reason for this requirement is to limit the application of section 355 to certain specified distributions or exchanges with respect to the stock or securities of controlled corporations incident to such readjustment of corporate structures as is required by business exigencies and which, in general, effect only a readjustment of continuing interests in property under modified corporate forms. Section 355 contemplates a continuity of the entire business enterprise under modified corporate forms and a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange. All the requisites of business and corporate purposes described under § 1.368 must be met to exempt a transaction from the recognition of gain or loss under this section.

(d) *Stock and securities distributed.* The distributing corporation must distribute—

(1) All of the stock and securities of the controlled corporation which it owns, or

(2) At least an amount of the stock which constitutes control as defined in section 368(c). In such

case all, or any part, of the securities of the controlled corporation may be distributed.

Where a part of either the stock or securities is retained under (2), it must be established to the satisfaction of the Commissioner that such retention was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Ordinarily, the business reasons (as distinguished from the desire to make a distribution of the earnings and profits) which support a distribution of stock and securities of a controlled corporation under paragraph (c) of this section will require the distribution of all of the stock and securities. If the distribution of all of the stock and securities of a controlled corporation would be treated to any extent as a distribution of 'other property' under section 356, this fact does not tend to establish that the retention of any of such stock and securities is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

(e) *Principal amount of securities.* (1) Section 355(a)(1) is not applicable if the principal amount of securities received exceeds the principal amount of securities surrendered or if securities are received and no securities are surrendered. In such cases, see section 356.

(2) If only stock is received in a transaction to which section 355 is applicable, the principal amount of securities surrendered, if any, and the par or stated value of stock is not relevant to the application of such section. For example: All of the stock of Corporation A is owned by X, an individual, and securities in the principal amount

of \$100,000 which were issued by Corporation A are owned by Y, an individual. Corporation A distributes all of the stock of a controlled corporation to Y in exchange for his securities. The par or stated value of the stock of the controlled corporation is \$150,000. No gain or loss is recognized to Y upon the receipt of the stock of the controlled corporation.

(f) *Period of ownership.* (1) For the purposes of determining whether gain or loss will be recognized upon a distribution, stock of a controlled corporation acquired (in a transaction in which gain or loss is recognized, in whole or in part) within five years of the date of the distribution of such stock is treated as 'other property'. Section 355 does not apply to a transaction which includes a distribution of such stock. See section 356. The stock so acquired is 'stock', however, for the purpose of the requirements respecting the distribution of stock of such controlled corporation provided in section 355(a)(1)(D).

(2) Paragraph (f)(1) of this section may be illustrated by the following example:

*Example.* Corporation A has held 85 of the 100 outstanding shares of the stock of Corporation B for more than five years on the date of distribution. Six months before such date, it purchased 10 shares of such stock. If all of the stock of the controlled corporation owned by Corporation A is distributed, section 355 is not applicable to such distribution since the 10 shares would represent 'other property.' See, however, section 356. If, however, for proper business reasons it is decided to retain some of the stock of Corporation B, then the determination of

the amount of such stock which must be distributed under section 355(a)(1)(D) in order to constitute a distribution to which section 355 is applicable must be made by reference to all of the stock of the controlled corporation including the 10 shares acquired six months before such date and the 5 shares owned by others. Similarly, if, by the use of any agency, the distributing corporation acquires stock of the controlled corporation within five years of the date of distribution, for example, where another subsidiary purchases such stock, such stock will be treated as 'other property.' If Corporation A had held only 75 of the 100 outstanding shares of stock of Corporation B for more than five years on the date of distribution and had purchased the remaining 25 shares six months before such date, neither section 355 nor section 356 would be applicable.

(G) *Active businesses.* The rules of section 355(b) and § 1.355-4, relating to active businesses, must be satisfied.

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#### **Sec. 1.1502-31. Bases of tax computation.**

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(b) *Computations.* In the case of affiliated corporations which make, or are required to make, a consolidated return, and except as otherwise provided in the regulations under section 1502:

(1) *Taxable income.* The taxable income of each corporation shall be computed in accordance with the provisions covering the determination of taxable income of separate corporations, except:

(i) There shall be eliminated unrealized profits and losses in transactions between members of the affiliated group and dividend distributions from one member of the group to another member of the group (referred to in the regulations under section 1502 as intercompany transactions);

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